Role of the Bahamian Financial Services Sector in the Transformation and Growth of the Bahamian Economy

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Introduction

It is an honour to speak at this 30th Annual Bahamas Business Outlook and to reflect on the related themes of "recover, adapt and advance." I would like to focus my presentation on the role of the financial sector in this process, from the perspective of transformation and growth, and to relate this to the ways in which the policies and initiatives of the Central Bank can be supportive.

Although the COVID-19 pandemic has sharpened the focus on our economic vulnerabilities, Hurricane Dorian provided a stronger jolt, because it highlighted the growing threat from climate change that is more challenging to resolve than just diversifying our economic base. Adaptation for greater climate change resilience will be a costly, transformative undertaking, because it also puts a premium on sturdier infrastructure that has to be developed and on the stronger financial insurance arrangements that are needed.

Also relevant now is improving average growth prospects, through a strategy underpinned by higher rates of savings and investments, and increased international competitiveness. The Bahamas has to strive for faster growth in spite of the pandemic, to finance more adequate public services and to reduce a high public debt burden that pre-dated the pandemic. Now, because of the pandemic, new debts are mounting, just to stabilize the economy.

The financial sector has to support our adaptation and growth, promoting inclusiveness and access, and facilitating healthier savings and investment outcomes. The pandemic has also accelerated our thinking around digital transformation, but this too is driven by the need to reduce service delivery costs and make public and private sector services available, on an equal basis throughout our scattered islands.

Recent Economic Developments and Prospects

With the toll of the pandemic, the Bahamian economy contracted by at least 15% in 2020 and is not expected to fully recover until possibly 2023. Although there is more clarity over when the recovery will start, considerable head winds could remain in the very near-term, as developed countries cope with the most recent wave of COVID-19 infections, and perfect their vaccination rollout strategies. The possibility of not achieving sufficient inoculation coverage until early in 2022, places travel and tourism on a recovery path that would be strongest in the overlap between 2022 and 2023.

To illustrate, the uneven impact of COVID-19, according to the IMF, global economic growth 2020 is being projected to be about 8 percentage points less than what it would have been without the pandemic's effect. For the major industrial countries, there was a *7* percentage point difference; for the Caribbean tourism dependent economies, the difference was about 11 percentage points, while The Bahamas saw a reversal of fortune of nearly 15 percentage points.

In the experiences, pandemic losses to tourism dependent countries outweigh those of other economies by far. The vulnerabilities that these narrow-base economies face is nothing that can be repaired in the near-term. The question is whether, in The Bahamas' case we will reach far enough in our reforms to shift the economic base towards greater future contribution from other viable industries and sectors.[1]

As we concentrate on tackling such exposures, and progressing beyond present difficulties, the economy will also have to execute effectively on potential domestic and foreign investment activities. These provide much needed immediate stimulus for construction, and continue to expand capacity that would sustain higher activity, particularly in tourism, once the pandemic recedes.

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[1] In economic language, the medium-term can cover a period of up to 5 to 10 years.

Countries like The Bahamas have also had more severe economic responses to COVID-19, because of our constrained policy environment. The fixed exchange rate, which is justified for our economic profile, takes the Central Bank out of consideration as a source of stimulus. Providing stimulus in a countercyclical fashion would have endangered the exchange rate, by encouraging spending on imports of goods and services that diminished the foreign reserves.[2] Instead, the Central Bank's policy stance has been to conserve foreign exchange for essential uses, which has meant suspending net access for international portfolio investments and adopting a limited range of other measures.

It is the ability to respond through fiscal policy that has most defined The Bahamas' capacity to cope during the pandemic. Again, the policy reach has been limited. Although a sizeable deficit has emerged, the outcome has been almost entirely the result of the decline in revenues. This has been set against the need to provide, within our fiscal means, basic support for the most vulnerable persons. It contrasts with the more general stimulus that governments in advanced countries have been able to provide. Still, this came at the expense of taking on new debt. Having the headroom to take on new debt, and to do so while preserving the viability of the exchange rate helped to defined how aggressive the government's interventions could be to stabilize the economy.

Recovering and advancing is about comfortably reducing the public debt burden over the medium-term, so that the Government can respond again when necessary to cushion economic setbacks. Having a successful outcome from the medium-term fiscal consolidation or debt reduction strategy means strengthening our insurance policies against future shocks, of which climate change poses the greatest risks.

The fiscal response to the crisis was still not independent of the need to pair stimulus with access to foreign currency—in this case, financing a large share of the deficit in foreign currency. As such, the government's foreign currency borrowing have provided inflows to supplement the private sector's need and bolster the foreign reserves. In 2020, total foreign currency inflows through the private sector, as measured from commercial banks' purchases of foreign exchange, fell by almost 33.0%*.* Although expressed demand for foreign exchange to pay for imports of goods and services fell by approximately 13.0%, this left a shortfall of over $400 million that had to be provided from other sources. The gap was closed by net inflows from government borrowing, revealed in data on the net foreign currency transactions between the Central Bank and the government.

There is no deliberate intention to grow the foreign reserves through the government's debt operations. However, the reserves closed out 2020 above $2.0 billion, its highest end of year position on record. However, this was simply a matter of timing, as the government still had not fully drawn down its resources for spending. As this happens over the first half of 2021, and as the private sector's needs stay above tourism inflows, balances will reduce. It is still expected

[2] Central Bank stimulus would have required matching access to foreign exchange or a surplus of foreign reserves that could be depleted without concerns.

therefore that the economy will exit the pandemic with less reserves than at the start of it. In addition, some net private sector proceeds from Hurricane Dorian still remain to be withdrawn from the reserves, as the rebuilding (that would also fuel imports) is still proceeding slower than was expected.

There have been continuous attempts to infer whether the Bahamian dollar was at risk of devaluation, because of the pandemic. The currency is not at such imminent risk. This is because of level of the reserves both now, and where they should resume their rebuilding. These balances match slightly more than 100% of the Central Bank's core liabilities,[3] compared to the legally mandated floor of 50%. The liabilities move in opposite direction to the reserves, only when the Bank lends to the government. However, there is increased policy discipline in this regard, since the 2020 Central Bank Act has imposed a comprehensive ceiling on how much the Bank can lend to the government. When the reserves begin to be drawn down, it is projected to be the case again that Central Bank's core liabilities will shrink.

It is not in our economic interest to tolerate the inflation, financial instability or erosion of middle-class wealth that would accompany devaluation. Moreover, it does not strengthen our international competitiveness, which has to come from outcomes such increase workforce productivity, education and skills upgrade, and the familiar list of required improvements in the ease of doing business. The medium and long-term hedge against devaluation, which would escape an extreme fiscal austerity outcome, is still healthier public finances, and a transformed culture of increased domestic savings. Both of these reveal themselves in healthier levels of foreign savings, better access to foreign borrowing when it is needed, and less panicky investors who are less likely to spark runs on supplies of foreign exchange during times of economic stress.

In times of extreme economic shocks, the balance sheets of financial institutions are also placed under strain. For domestic banks and credit unions, credit losses are therefore expected to increase, especially as the economy traverses 2021. The spike in businesses with significantly reduced or eliminates revenues, and the sharply elevated unemployment, has placed a significant number of borrowers in deferred loan payment status at banks and credit unions or already. Through November almost 10*%* of private sector loans at banks were in this state, although much reduced from one-third of exposures that were being accommodated in June of 2020. As 2021 progresses, and banks move further away from the end of the deferral period, more of these loans could become non-performing, against which lenders would begin to realise greater losses. However, the losses are expected to be much less than were experienced after the 2008 global recession. In this regard, the stability of the financial system is not threatened, because Banks have more than enough excess capital to absorb losses; and confidence in credit unions, is now bolstered by their participation in the Deposit Insurance Corporation and turnaround in tourism that would become more define later in 2021.

In the post-pandemic recovery, it is expected that the economy will eventually settled at a potential growth rate of about 1.5% per annum. The 2022 gains would appear sharply stronger,

[3] Demand liabilities.

but only because it would capture a greater share of tourism's expected recovery to pre-2020 levels. This will again position the foreign reserves for gradual growth, and shift the attention to reducing public debt burden.

To adapt and advance however, means positioning the economy for healthier more resilient expansion above this 1.5% annual potential.

Let me sketch how the financial sector would fit into this space.

Increasing Domestic Savings and Investments

Increased savings would expand the resources available for investment in business, infrastructure and growth. For small investors, the Central Bank has committed to work closely with the Ministry of Finance to establish a government savings bonds scheme, to allow savers to gradually build-up holdings in government instruments, providing access to the liquidity that such assets provide and their competitive returns prospects. Over time, a savings bond framework would be expected to moderately increase the share of the debt held by small retail investors, without giving the Government any incentive to borrow more than it needs.

The local capital markets will also have to continue to develop more collective investment opportunities for Bahamian residents. Infrastructure development is one area to target—within the public private partnership frameworks—as are increased, strictly private ventures. Insofar as Exchange Control relaxation is concerned, the Central Bank will work further to increase domestic firms' access to foreign currency financing, when the proposed ventures have positive impact on foreign exchange or if they are in keeping with other national development priorities.[4,5]

Outlets for international portfolio investments will also increase, as complements for improved domestic savings and could help encourage savings. For this, the Central Bank will stay focused on gradual Exchange Control liberalization. Our recent accommodations have favoured use of licensed trust companies, with the authorised agent status, as outlets for self-managed portfolio investments. However, progressive reforms will also be explored to promote increased use of BISX-listed depository receipts marketed by the local broker-dealers firms that finance purchases of securities listed on foreign stock exchanges. At present, access to foreign exchange is suspended for both sets of activities, but this is only a temporary measure, which does not prevent residents from trading in accounts already established.

Converting savings into investments is also dependent on greater ease of access to commercial credit. For this, enhancing the security and transparency of domestic lending frameworks is vital. The Central Bank's contribution includes an ongoing role in establishing the credit bureau. The

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[4] As communicated previously by the Central Bank, the sectors and activities include the following: agriculture & fisheries, manufacturing, transport (land, sea and air), tourism (hotels & restaurant), construction & real estate for residential tourism, energy & energy conservation, education, health, ICT and infrastructure.

[5] More interventions will also be target public education around access levels already conceded for businesses to borrow or raise equity in foreign currency.

bureau's credit information reports will help to reduce uncertainties around the quality of potential borrowers, improving the medium and long-term access to both business and personal credit. The bureau, which was licensed at the end of 2019, is now setting up operations, and should begin to produce live credit reports data by start of the second quarter of 2021. Commercial credit reports will start to be generated in a subsequent phase of operations.

The next initiative, on which there is already collaboration with the Ministry of Finance is to set up a collateral registry for commercial lending. This would establish security against a range of moveable, even intangible assets. The Central Bank will commission the consultancy on the diagnostic study for the registry in the first quarter of this year. This will produce an outline of recommended legal reforms to establish the registry; and a set of recommendations on the operational framework for the registry.

Digital Transformation, Inclusion and Access to Finance

The digital transformation of the economy reinforces the importance of the current modernisation thrust for Bahamian financial services. In the payments space, we are destined to see less use of cash; diminished to eliminated use of checks;[6] and a completely remote, electronic process for establishment of financial services. Having financial inclusion as an outcome in this process is vital, so that all residents and business can have access to the new delivery channels for domestic financial services.

At present about 9 out of 10 surveyed adults in The Bahamas have access to at least a savings account at a bank or credit union; at least 86% of the adult population have access to smart mobile devices; and there is high awareness of new mobile payments products, including the central bank digital currency, the Sand Dollar that is being rolled out nationally.[7] There will be a subset of the persons who do not have full access to smart phones or who are just uncomfortable. For them, smart cards will be an option for participation in this mobile wallet space. However, to encourage the adoption process, the appropriate public education and consumer protection focus will couch the Central Bank's initiatives.

At the low balances level, mobile wallets offered by licensed Bahamian financial institutions can safely store funds, and provide similar convenience to maintaining low-value deposit accounts. Although they do not substitute for the interest bearing features of deposits, they are trending in 2021 towards allowing anyone presently without a deposit account to receive electronic payments from any origin inside The Bahamas, including the government, an employer, or any other holder of a digital wallet. Mobile wallet accounts can be established remotely, adhering to the simplified, robust, but tailored customer due diligence standards that are established for bank accounts. In 2021, the Central Bank will also develop complimentary streamlined guidance to ease the account opening process for businesses.

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[6] In 2020, the Ministry of Finance agreed with commercial banks to target an 80% reduction in use of check over five years and a 50% decrease in domestic use of cash over this same period.

[7] The most recent survey on this subject was completed in the fall of 2020. Results will be published in January 2021.

As part of the Sand Dollar Infrastructure, the Central Bank is finalizing an electronic customer due diligence or e-KYC system. This would eliminate distance and remoteness as a factor in establishing financial relationships, and be available as a tool for all financial institutions.

Although the Central Bank can make significant progress in the near-term by satisfying the needs of regulated financial services providers, the Bahamian e-Government initiatives will still soon be necessary to sustain a digital ID system; and to provide the vital information systems for commercial entities that would also assist the customer due diligence processes of financial institutions. This will free up more financial sector resources to invest in developing and strengthening regulatory technologies, such as around financial transactions monitoring, and the integrity of transactions.

In the near and medium-term, governance, transparency and consumer protection will also require bolstering. These are interconnected themes, geared at empowering and protecting users of domestic financial services. In particular, a continued deepened focus will remain on financial literacy, to strengthen understanding of how financial services and the economy works, including the policy trade-offs that are faced when The Bahamas navigates economic shocks. Literacy would continue to empower stakeholders to ask the right questions, to independently interpret and effectively use economic and financial sector indicators; and incentivise institutions like the Central Bank to be increasingly transparent about their policies.

The Central Bank is also looking to promote greater transparency around provision of financial services. One near-term deliverable will be publication of more comparable information on the fee structure of financial products across banks, using a standardized template that has been already developed. This would promote more informed choices across products and services being provided by competing institutions. The Bank will also consider what regulatory avenues can be exploited promote transparency around fee setting practices under the Payment Systems Act. In addition, as regard mobility and choice, the Central Bank will explore medium-term reforms around the feasibility of open banking, having full regard to regulatory proposals that would encourage product development, but keep consumer protection in full view. From an inclusion perspective, we will also explore the feasibility of incorporating universal access criteria into the basic product mix of financial institutions, through potentially a basic, no-frills, fee-regulated instrument that each institution would have to provide.

The Bahamian public will also have to embrace the implications of what it means to achieve greater efficiencies in financial services as regard changes in the physical landscape. We should expect therefore more shrinkage in the branch networks of banks and credit unions; and anticipate that there could be a future of some strictly digital banking operations. It means that the employment levels in the sector could reduce as more functions give way to automation. But the emphasis during such transformation has to stay on improving efficiency and access.

Taking a more holistic view of consumer protection, the Bank is now committed to completing the establishment of the Financial Services Ombudsman role early in 2021. Initially, the role will strengthen advocacy around service delivery within Central Bank-supervised institutions, and identify where principles-based regulations can be deployed under the existing laws within the

Bank's remit. In addition, the Ombudsman will focus on proposals for consumer financial protection that might require new comprehensive regulations. For example, the current scope which the Central Bank has in the payments space would not impact credit products.

Other Non-Central Banking Considerations

In other forums, there has been a broader discussion of how the financial sector can play a role in, adaptation, transformation and growth, which have remained in focus. This includes the importance of some regulatory mandate for private insurance for hurricane; and other resilience-enhancing measures to limit long-term losses to both the public and private sectors from climate change risks. The Bahamas has to achieve more significant development of non-bank channels to direct capital to the private sector, exploiting channels that the securities industry might promote. Concluding on the regulatory framework for private pension schemes is also vital. In this context emphasis has to be placed on increasing the level of savings amassed though these schemes.

Conclusions

The Pandemic and Hurricane Dorian did not add new perspectives around either the imperatives for stronger growth or increased resilience for the Bahamian economy. Similarly, there was prior understanding of the kinds of adaptation that were needed in The Bahamas. In this regard, either deepening or accelerating the Bahamian financial sector's supporting role in this process is important. As outlined, the sector has to facilitate more savings, and help to transform more of the savings into investments. Focus on the financial sector can also strengthen our foreign exchange market resilience and our capacity to stabilize in the midst of shocks. But these inroads require adaptation to a more digital infrastructure, and a deliberate emphasis on inclusion and access throughout our scattered islands. Systems of governance must also evolve further in ways to promote consumer choice and consumer protection. Collectively, these themes will continue to underpin the Central Bank's initiatives.